Snell & Wilmer L.L.P.

UNDER CONSTRUCTION

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contents

Message From the Editor:

As construction work is being completed, everyone wants and expects to be paid. Although many concerns may arise throughout a construction project, receipt of payment may be the greatest concern. Payment is the lifeblood of any construction project. As a result, it is important to understand who will make payment, and when.

Regardless of whether you are an owner, developer, design professional, supplier, general contractor or subcontractor, you should understand the impact of "pay-if-paid" and "pay-when-paid" provisions in the general contractor/subcontractor agreements. For a subcontractor and general contractor, it is absolutely essential. Understanding their key differences is vital when drafting or reviewing your contracts. Contract language must be clearly and carefully drafted and reviewed. This newsletter can serve as a reference to provide awareness of "pay-if-paid" and "pay-when-paid" clauses in the Snell & Wilmer L.L.P markets – Nevada, Colorado, California, Utah, and Arizona

Under Construction is provided as a service to highlight legal trends and issues commonly faced in the construction industry. Please contact us if you have any questions or suggestions. Let us know how we can improve this publication to provide even more value to you.

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Nevada May Enforce Pay-If-Paid Clauses If Carefully Drafted

By Leon F. Mead II, Esq. & Marek P. Bute, Esq.

Recently, there has been much debate in the Nevada construction market over whether pay-if-paid or pay-when-paid clauses are valid. Many Nevada subcontractors, relying on 2003 and 2005 revisions to the Nevada Mechanic's Lien Law ("MLL") and the Private Work Prompt Payment Act ("PPA") have stated categorically that pay-if-paid contractual provisions are unenforceable. General contractors on the other hand point to references in the PPA that specifically recognize such clauses and argue, therefore, that pay-if-paid provisions are valid. Both of these positions have a fair amount of "grandstanding" attached to them: At this point, no Nevada court has addressed the issue and no Nevada statute directly states that such clauses are either valid or invalid. As the economy continues to tighten, the reliability of such contractual provisions become critical to the daily operations of Nevada contractors.

Defining the Clauses

A "pay-if-paid" provision creates a "condition precedent" to a general contractor's obligation to pay, shifting the entire risk of the owner's nonpayment to the subcontractor. A "pay-when-paid" clause requires the subcontractor to delay his receipt of payment until the contractor has had a sufficient period of time to collect payment from the owner. Few jurisdictions have directly upheld the enforcement of "pay-if-paid" provisions unless the provision "clearly and unambiguously" reflects the parties' intent. Conversely, a "pay-when-paid" clause does not present a significant hurdle for courts, as even the states that strictly prohibit "pay-if-paid" provisions acknowledge that a "pay-when-paid" provision may be enforceable, if applied as a reasonable timing mechanism.

Nevada Law

Under normal circumstances between businesses (and in the absence of direct statutory prohibitions), Nevada would generally enforce unambiguous contractual provisions. In *Dayside Inc.*, the Nevada Supreme Court found that "a clear and unambiguous provision in a contract whereby a contractor waives his right to a mechanic's lien" is valid and binding. The Nevada Supreme Court held that "absent a prohibitive legislative proclamation, a waiver of mechanic's lien rights is not contrary to public policy."

In 2003 and again in 2005, Nevada implemented "prohibitive" legislation impacting the ability of contractors and owners to "contract around" statutory payment requirements and liens by enacting certain revisions to the MLL and the PPA. The MLL provides mechanics' liens for unpaid contractors against the property on which their

work is performed. The PPA similarly governs agreements between a higher-tiered contractor and lower-tiered subcontractors by specifically outlining payment procedures, notice requirements and other rights related to performance and/or termination of performance. Both of these statutes contain specific language making agreements modifying or circumventing their provisions "contrary to public policy and void." See NRS § 108.2453(2) and NRS § 624.628(3). In effect, the Dayside Court's "bluff" has been called. The validity of contractual provisions affecting payment in Nevada must now be analyzed in terms of these statutory mandates.

The Effect of the Prompt Payment Act and Mechanics Lien Laws

At the outset, it should be noted that the PPA does not mandate that payment must be made by a certain date. Rather, the PPA merely allows a lower tier contractor to stop work on a project if payment is not made when due, unless the higher-tier contractor has provided proper notice and documentation of a reason to withhold that payment. See NRS § 624.626(1). Critically, under the PPA, a subcontractor is not allowed to terminate his contract after stopping work if the reason he has not been paid is a lack of payment from the owner and the subcontract contains a "pay-if-paid" or "pay-when-paid" clause. See NRS § 624.624(1)(b). This option is specifically omitted from the applicable reasons that a subcontract may be terminated under NRS § 624.626(2) or (5). Equally important, it is only upon termination that a subcontractor may sue the general contractor for damages under NRS § 624.626(6). Thus, so long as the provision does not prevent a lower-tier contractor from stopping work as a result of lack of payment, nothing in the PPA should be construed to invalidate a "pay-if-paid" or "pay-when-paid" provision.

Having established that the PPA should not prevent payment protection provisions, we must determine whether a "pay-if-paid" or "pay-when-paid" provision would operate as a mechanic's lien waiver. A mechanic's lien claimant has a right to record a lien for the unpaid balance of his construction contract, regardless of whether the work thereunder is "performed, furnished or to be performed or furnished." See NRS § 108.222(1)(a). Whether or not payment is due for that work is irrelevant to whether the contractor is entitled to record a mechanic's lien. It is only upon trial that "the court shall award to a prevailing lien claimant … the lienable amount found due to the lien claimant." See NRS § 108.237(1). As such, whether a pay-if-paid or a pay-when-paid provision violates the Nevada prohibition on a waiver of a mechanic's lien claim will turn on the specific language of the payment provision – not whether payment is due under the subcontract. It would appear then that if a pay-if-paid or pay-when-paid clause can be enforced, while still reserving the right of the affected subcontractor to record and prosecute a mechanic's lien against the owner, the general contractor may be able to enforce the pay-if-paid or pay-when-paid clause.

It is certain that if great care is not used to ensure that a pay-if-paid or a pay-when-paid provision is drafted with Nevada law clearly in mind, the provisions may not have its intended consequences. But it is equally true that a careful attempt to reserve to a subcontractor the right to proceed on his mechanic's lien against the owner may keep such a clause enforceable between the general contractor and the subcontractor. Each pay-if-paid contract provision should be reviewed by a knowledgeable construction attorney to ensure the best protection for the client and to analyze its enforceability.

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Colorado Law Concerning Pay-If-Paid/ Pay-When-Paid Clauses

By Scott Sandberg

Colorado's approach to "pay-if-paid" clauses can be summarized as follows: pay-if-paid clauses are disfavored, but may be enforced under strict conditions. As a general rule, an owner's failure to pay a general contractor does not relieve the general contractor from its obligation to pay its subcontractor. Colorado general contractors have often responded with contract provisions that tie the timing of any required payment to the subcontractor on the general contractor's actual receipt of payment from the owner. However, Colorado courts generally disfavor such provisions and thus, when possible, interpret such provisions as creating only a "pay-when-paid" obligation—meaning that, even if the owner makes no payment, the subcontractor must be paid within a reasonable time after the work is performed. An enforceable "pay-if-paid" clause, in contrast, conditions the subcontractor's right to receive payment on the contractor's receipt of payment and, if the general

contractor never receives payment from the owner, its obligation to pay the subcontractor never arises.

The leading Colorado case on pay-if-paid clauses is the Colorado Supreme Court's opinion in *Main Electric, Ltd. v. Printz Services Corp.* The subcontract in the Main Electric case provided that the general contractor would pay the subcontractor "provided like payment shall have been made by Owner to Contractor." The Colorado Supreme Court held that this clause constituted a pay-when-paid clause, because it did not impose a condition precedent that shifted the risk of the owner's nonpayment from the general contractor to the subcontractor. The court found that, in order to "create a pay-if-paid clause in a construction contract, the relevant contract terms must unequivocally state that the subcontractor will be paid only if the general contractor is first paid by the owner and set forth the fact the subcontractor bears the risk of the owner's nonpayment." In other words, "[i]f the risk of the owner's nonpayment is to be shifted from the general contractor to the subcontractor, then this shift must be clearly articulated in the agreement."

In light of the *Main Electric* decision, a general contractor who intends to include a pay-if-paid clause in its subcontract should include the following specific statements:

- Payment by the owner to the contractor is a "condition precedent" to the contractor's obligation to pay the subcontractor;
- The contractor is relieved of any obligation to pay the subcontractor if the owner does not pay the contractor; and
- The parties understand and agree that the subcontractor, not the general contractor, bears the risk of the owner's nonpayment.

Without this language, the clause could instead be deemed a "pay-when-paid" clause, meaning the contractor can delay payment to the subcontractor for a reasonable time period but not until the owner pays the contractor. On the other hand, a subcontractor must understand this risk, and if it does not want to take the risk of the enforceability of such a clause, the subcontractor must modify or strike such language in the subcontract or through an addendum to the subcontract before signing it.

Other factors to bear in mind in drafting and reviewing pay-if-paid clauses in Colorado include:

1) Prompt pay requirements for public projects. Colorado statutes provide subcontractors with certain rights to prompt payment on public construction projects exceeding $80,000, under which subcontractors must be paid within seven calendar days of receipt of payment by general contractor from the public entity.

2) Mechanic's liens and surety bond remedies. Colorado courts have not definitively addressed whether pay-if-paid clauses impact subcontractor rights under Colorado mechanic's lien laws. However, Colorado courts have clearly stated that

mechanic's lien waivers are not favored in Colorado and the mechanic's lien provisions are to be liberally construed. Moreover, C.R.S. § 38-22-119 mandates that agreements to waive, abandon, or refrain from enforcing mechanic's liens are only effective between contracting parties. Likewise, the impact of pay-if-paid clauses on surety bond remedies has not been addressed by Colorado courts.

3) Miller Act claims. Federal courts in Colorado have held that a pay-when-paid clause will not defeat a Miller Act claim unless it is "clear and express." To be effective, the clause must, at a minimum, specifically mention the Miller Act and unambiguously express its intention to waive the rights provided by it. Even such a clear and express clause may not be enforced by the federal courts.

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California Pay-If-Paid/Pay-When-Paid Analysis

By Steve Graham and Ahmed Ibrahim

Consistent with California's 150 year old constitutional policy of ensuring laborers and material suppliers are duly paid for their goods and services, California declares null and void any contractual provision waiving or impairing mechanic's lien rights unless done so in connection with receipt of payment or done conditionally with assurance of payment. Cal. Civ. Code § 3262. Accordingly, California takes a more strict and rigid approach to pay-if-paid clauses. It is now firmly established that a provision providing that an owner's payment to the general contractor is a condition precedent to the contractor's obligation to pay its subcontractor is unenforceable because it violates the public policy underlying the anti-waiver provisions of the mechanic's lien laws. *Wm. R. Clarke Corp. v. Safeco Insurance Co.* "Pay when paid" provisions, on the other hand, are enforceable. A "pay-when-paid" clause states that the subcontractor will be paid "when" the general contractor is paid without specifying that receipt of payment is a condition precedent to the contractor's obligation to pay. However, such clauses are disfavored and given a limited construction to mean that the subcontractor will be paid upon his performance or within a reasonable time thereafter.

Yamanishi v. Bleily and Collishaw, Inc. These principles apply to both public and private works projects.

It should be standard practice for subcontractors to insist on payment terms that require the general contractor to remit payment within 10 days of receiving payment from the owner unless the general contractor submits in writing that it has a good faith dispute over the performance of the work and provides monetary quantification of the amount in dispute. Thus, the general contractor must, within 10 days of receiving payment earmarked for a subcontractor, either make payment or identify in writing any work in dispute and the reasonable cost (plus 50%) to fix it. If one of the two obligations is not fulfilled, the general contractor is potentially liable for 2% per month penalties, plus attorney fees if legal action is required.

But, other than researching the owner's financial condition before the general contractor signs the contract with the owner, how can the general contractor protect itself from a defaulting owners? After *Clarke,* the legislature responded by establishing the general contractor's right to issue a "10 Day Stop Work Order" in private works projects. Cal. Civ. Code § 3260.2. Under this remedy, if the general contractor is not paid by the owner within 35 days from the date payment is due under the parties' contract and there is no dispute as to the satisfactory performance of the general contractor, the contractor may stop work on the project. If the detailed procedures required under the statute are carefully followed, including posting advance notices at the jobsite and notifying all subcontractors, and payment is not made within the 10 day period, the general contractor or surety may seek a judicial determination of liability for the unpaid amount in an "expedited" court proceeding. While the teeth of this procedure has not yet been tested by the appellate courts, it would appear to provide some relief against the owner that would have previously been available from pay-if-paid contractual provisions before *Clarke.*

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Utah Courts Will Likely Enforce Pay-If-Paid/Pay-When-Paid Clauses

By Mark Morris

Although Utah historically has enforced contracts according to their terms, Utah's appellate courts will sometimes find a way to achieve a result that strikes them as more fair. Unfortunately, there are no Utah cases or statutes that directly address the enforceability of "pay-if-paid" or "pay-when-paid" clauses in contracts between general contractors and their subcontractors. Although these clauses are likely synonymous when any grammarian is asked to interpret them, courts around the country, and likely Utah, will see these two clauses as being different in meaning. If a "pay-when-paid" clause is used, a majority rule around the country appears to be that a general contractor will be given a reasonable amount of time to collect money from the owner before its obligation to pay the subcontractors arises. Such a clause is not, however, a defense if the owner fails completely to pay the general contractor. There will always be the inevitable fight over what is "reasonable," but such a clause will likely not protect a general contractor. If, however, the parties have agreed to a "pay-if-paid" clause, it is likely that Utah courts will enforce that clause and relieve the general contractor of any liability to the subcontractors, provided that the owner has not paid the general contractor for the work performed. Naturally, general contractors will always want to include a "pay-if-paid" clause, and subcontractors and suppliers will prefer that no such clause appear at all. If they must include such a clause, subcontractors will try to obtain the language "pay-when-paid".

Currently "pay-if-paid" clauses are more prevalent in Utah construction contracts. Utah lawyers representing subcontractors have been successful in lobbying the legislator to enact legislation that is favorable to subcontractors. For example, subcontractors have the right to obtain financial information about owners for purposes of filing liens. However, the efforts to obtain legislation that would bar "pay-if-paid" clauses outright have failed to date. This is in spite of the fact that high courts of both California and New York have apparently invalidated "pay-if-paid" clauses as being against public policy. The absence of any Utah case law suggests at least an implicit acknowledgment among parties on both sides of the issue that neither side will take the matter all the way to the Utah Supreme Court for an interpretation, because each side would risk losing a matter not only for themselves, but for every other general contractor or subcontractor that is similarly situated. We are not aware of any current efforts to persuade the 2007 Utah legislature to prohibit the inclusion of "pay-if-paid" or "pay-when-paid" clauses.

In sum, Utah remains a state that appears to be willing to enforce agreements made between parties bargaining at arms' length with one another. Given, however, the number of cases in Utah where there are inconsistent appellate court rulings, one must never assume that the four corners of the document are all that a Utah appellate court will be willing to examine in interpreting a contract.

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Arizona Law and the Enforceability of Pay-if-Paid/Pay-When-Paid Clauses

By Jim Sienicki and Teresa Anderson

This article addresses what is required to create a valid and enforceable "pay-if-paid" clause that conditions the subcontractor's right to receive payment on whether owner has paid the general contractor. In Arizona, in order to create a valid and enforceable "pay-if-paid" clause, the contract must exhibit the parties' unequivocal intent to shift the risk of the owner's nonpayment from the general contractor to the subcontractor. If the clause does not demonstrate this requisite intent, the clause will be construed as a "pay-when-paid" provision and require that the general contractor pay the subcontractor within a reasonable period of time after the subcontractor completes the work.

Recent Arizona caselaw demonstrates that the "pay-if-paid" contract language must be carefully and precisely drafted to be effective and must clearly establish that the owner's payment to the general contractor is a condition precedent to the general contractor's obligation to the subcontractor. However, the Arizona courts have not revisited the enforceability of "pay-if-paid" clauses since enactment of the Prompt Payment Act. It is possible that the Prompt Payment Act may change the analysis and courts might be even more reluctant to find a valid and enforceable "pay-if-paid" clause.

Arizona Caselaw

As a general rule, conditions precedent are not favored. In the 1965 *Darrell T. Stuart* construction case, the court held that in order to enforce a "pay-if-paid" clause, the parties must unambiguously intend to shift the risk of loss from the general contractor to the subcontractor. Otherwise, the

court will construe the clause as a "pay-when-paid" provision that merely affects the timing of payment. The court held it was a "pay-when paid" clause.

Thereafter, the Arizona courts have found sufficient evidence to demonstrate the requisite intent and overcome the presumption that the parties intended a "pay-when-paid" clause. For example, in *Capisano v. Phillips*, the contract provided that an architect would be paid out of specific loan draws the general contractor received and that this would be the only method of payment. The court found that limiting payment to a specific fund and as the only method of payment created a valid "pay-if-paid" clause.

On the other hand, Arizona courts have found that merely limiting the subcontractor's recovery to the amount the general contractor has received from the owner is not sufficient to create a valid "pay-if-paid" provision. In *Watson Construction v. Reppel Steel & Supply*, the contract stated "at all times" the subcontractor was to be paid to the extent the general contractor had been paid.

Similarly, in *Pioneer Roofing v. Mardian Construction*, the court found that a provision limiting the subcontractor's recovery to the amount received by the general contractor did not create a condition precedent. In both of these cases, the court found no evidence of the parties' intent that payment was to be made exclusively from the funds paid by the owner to the general contractor.

The most recent Arizona case, *L. Harvey Concrete v. Argo Construction & Supply*, appears to modify the Darrell T. Stuart analysis slightly and allow for more flexibility in the contract language. The court stated that it would be "overly technical and ill advised as a matter of general contract law to insist that no condition precedent is created unless the contract specifically states that payment will come 'exclusively' or 'only' from a specific fund." The court recognized these terms may assist in expressing the necessary intent, but they are not "magic words" required to create a condition precedent.

Effect of the Prompt Payment Act (A.R.S. § 32-1129 et seq.)

It is not known how the Prompt Payment Act will further change the analysis or enforcement of "pay-if-paid" clauses. In enacting the Prompt Payment Act, the Arizona legislature intended to ensure prompt payment to general contractors by owners and to subcontractors by general contractors. The Act states that "performance by a contractor, subcontractor, or material supplier in accordance with the provisions of a construction contract entitles [them] to payment…." Given the legislative intent, it is possible a court would find that once a subcontractor performs the work in accordance with the contract, they are entitled to payment within a reasonable time, and any additional impediments to payment (i.e. that the general contractor must first be paid) may be invalid. On the other hand, the *L. Harvey Concrete*

case had already been decided when the Prompt Payment Act was enacted. Since the legislature did not specifically invalidate "pay-if-paid" clauses in the Act, it is also possible that the court will decide that "pay-if-paid" clauses are still valid.

If the general contractor intends to shift the risk of non-payment and to create a valid "pay-if-paid" clause, it would be advisable to have a knowledgeable Arizona construction attorney draft the clause to maximize its chances of being enforceable. To show the clear intent required, it would be prudent for the "pay-if-paid" clause to specify that payment by the owner to the general contractor is a condition precedent to the subcontractor's right to payment and that the subcontractor is to be paid exclusively or only out of a specific fund created by payments received by the general contractor from the owner. On the other hand, if a subcontractor wants to know whether a particular "pay-if-paid" clause is enforceable, it should also consult with a knowledgeable Arizona construction attorney. Moreover, if the subcontractor does not want to take this risk, it should strike this clause before signing the subcontract. At a minimum, the subcontractor has to understand this risk in negotiating its subcontract price with the general contractor. However, until the Arizona Court of Appeals interprets a "pay-if-paid" clause in light of the enactment of the Prompt Payment Act, it is unknown whether "pay-if-paid" clauses will still be enforceable.

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Our Las Vegas Office is Moving…

Snell & Wilmer's Las Vegas, Nevada office is moving. The following is our new address and contact information, effective April 30, 2007.

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